



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

Large and Mid-Size
Business Division

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MEMORANDUM FOR INDUSTRY DIRECTORS, LMSB
DIRECTOR, FIELD SPECIALISTS, LMSB
DIRECTOR, PREFILING AND TECHNICAL GUIDANCE, LMSB
DIVISION COUNSEL, LMSB
DIRECTOR, COMPLIANCE, SBSE

FROM: Bobby E. Scott /s/ *Bobby E. Scott*
Industry Director
Natural Resources and Construction

SUBJECT: Field Directive on Timber Casualty Losses

INTRODUCTION

This memorandum is intended to provide direction to effectively utilize resources in the classification and examination of a Forestry Industry taxpayer. This LMSB Directive is not an official pronouncement of the law or the Service's position and cannot be used, cited, or relied upon as such.

BACKGROUND

The compliance risk associated with the valuation of timber casualty losses is significant. This risk is currently estimated at \$2.5 billion to \$5 billion for open return years, and represents the number one issue in the Forest Products industry. A Timber Casualty Loss Issue Guidance Team was formed to identify avenues through which this compliance risk may be reduced, including the development of pre-filing guidelines as well as post-filing audit and issue resolution tools.

The current issue involves the proper approach to valuation of the Single Identifiable Property (SIP) damaged or destroyed by the casualty event. Taxpayers generally identify the SIP as the entire depletion block (as allowed by Rev. Rul. 99-56) to maximize the basis limitation. However, they often fail to comply with regulations and case law requiring the valuation of the SIP, both before and after the casualty event, in order to determine the diminution in fair market value of the SIP as a whole. Instead, many taxpayers utilize an additive approach, whereby they determine the volume of timber damaged or destroyed and multiply that quantity by current unit rates. By using the "additive" approach, taxpayers frequently place a value on the loss that is much greater than the diminution in value of the entire block on a before and after basis.

IRS examiners face significant obstacles in determining the correctness of reported casualty loss claims. First, since Revenue Ruling 99-56 accepted the depletion block as the SIP, there has been little guidance describing the legal requirements for the valuation of timber casualty losses. In addition, since taxpayers rarely perform an appraisal of the SIP, IRS examiners must determine the accuracy of the short-cut valuation and frequently perform an appraisal of the SIP themselves--all with limited access to comparable sales data, time constraints, and a lack of clear guidance as to what must be valued.

RECOMMENDATION

To address this audit issue and improve consistency and quality of timber casualty loss examinations, the Timber Casualty Loss Guidance Team has developed examination guidelines (Exhibit A) and an Issue Paper on the Valuation of a Single Identifiable Property (Exhibit B). The purpose of the Director's guidance is to provide a simplified method for assessing whether IRS resource allocation is feasible when determining the issue of timber casualty losses. When reviewing the taxpayer data, if the values claimed by the Taxpayer are below the values computed under this simplified method, resources would not need to be expended. When the claimed loss is greater than the amount computed under the simplified method, the examiner should perform the necessary risk analysis to determine if a valuation of the loss is required.

The assessment of the valuation of a casualty loss under the Director's guidance consists of three steps.

- First, a gross timber loss is calculated. This consists of the total value of the, reproduction, premerchantable, and merchantable timber that is damaged or destroyed. The respective values are computed as described below using published third-party sources for merchantable timber and capitalization of establishment costs for reproduction.
- Next, the allowable loss is determined, by applying a size adjustment, if appropriate, to the gross timber loss.
- Finally, the deductible loss is computed, which is the lesser of the allowable loss, or the adjusted timber basis in the depletion block.

Four factors determine the value of the loss under the Director's guidance:

- 1) The volume of timber damaged or destroyed;
- 2) The published unit stumpage rates chosen for the merchantable timber;
- 3) The valuation procedures specified for the, reproduction and premerchantable timber, and
- 4) The size adjustment, if appropriate, for the timber block.

Factors 2 through 4 affect valuation as follows:

A.) Unit timber values under the Director’s guidance method must be determined in a readily verifiable procedure. Average timber values from widely accepted timber price reporting services must be utilized in determining the unit timber values. Examples of acceptable services include Timber Mart South or the Pennsylvania Timber Price Report. Other potential sources include severance tax schedules published by state taxing or forestry authorities. The selection of the reporting service values must be consistent with the time period, the location of the timber casualty, and also the product class of the timber must correspond with the appropriate value claimed (i.e. pulpwood prices must be used for pulpwood).

B.) The reproduction values, on a per acre basis, must be determined by using the establishment cost of new plantations for the year in which the loss occurred and capitalizing this cost at the corresponding Farm Credit Bank District Rate for each year equal to the age of plantation which is the subject of the loss. This rate is published annually in Revenue Rulings, such as Revenue Ruling 2002-26. The Farm Credit Bank District rates chosen must correspond with the affected block location.

C.) It is generally accepted in forestry literature as well as in valuation studies that large blocks sell for lower per unit values than smaller blocks. For application of the Director’s guidance, therefore, the gross timber value for large blocks must be reduced as follows:

| Block Size in Acres | Size Adjustment (Reduction) |
|---------------------|-----------------------------|
| <100,000 | None |
| 100,000 – 300,000 | 15% |
| 300,000 – 500,000 | 20% |
| > 500,000 | 25% |

These size reductions must be applied both to the merchantable and the premerchantable timber values, on a block by block basis. No “reengineering” of original depletion block sizes will be permitted allowing the taxpayer to take advantage of the lower size reductions outlined above. Any change in block sizes will require approval as an accounting method change.

EXAMPLES:

The following examples illustrate the application of the Director’s guidance.

Example 1: A fire destroyed 30 acres of taxpayer X’s pine plantation. X’s total ownership consisted of 2,000 acres with a total basis of \$400,000. The entire property was treated as one depletion block. At the time of the fire, each acre contained 30 cords of pine saw timber. The Timber Mart South price per cord for the applicable

timber is \$90. X's loss is (30 acres x 30 cords/acre x \$90 / cord) \$81,000. No size adjustment is applied since the depletion block is less than 100,000 acres.

Example 2: A hurricane destroyed 13,000 acres of Y's plantation located in South Carolina on September 28, 2003. The destroyed acres consisted of 3,000 acres of 5 year old reproduction (generally < 15 years of age) with a plantation establishment cost in 2003 of \$200 per acre and 10,000 acres of merchantable timber containing an average of 25 cords per acre. The plantation was part of Y's Southeast U.S. depletion block, which contained 250,000 acres with a total timber basis of \$45,000,000. The applicable five-year farm credit rates are as follows: (1998 – 9.32%, 1999 – 9.65%, 2000 – 9.82%, 2001 – 9.90%, and 2002 – 9.68%). The reproduction is valued at \$200 capitalized at the appropriate rate for 5 years which equals \$317.35 per acre. In addition to the reproduction, merchantable pine pulpwood was destroyed. According to Timber Mart South the average pulpwood timber price is valued at \$20 per cord. Y's loss is calculated as follows. The taxpayer lost 250,000 cords of pine pulpwood (follow procedures for volume verification in Exhibit A). The gross timber loss is the 250,000 cords x \$20/cord + 3,000 acres of reproduction x \$317.35/ acre or \$5,952,050. Because the destroyed timber was in a block that is greater than 100,000 but less than 300,000 acres the gross timber loss must be reduced by fifteen percent (15%) to determine the allowable loss. The calculated loss is \$5,952,050 – (\$5,952,050 x 0.15) or \$5,059,242. The adjusted basis of the depletion block, (45,000,000) is sufficient to absorb the calculated loss of \$5,059,242, so the entire \$5,059,242 is deductible as a casualty loss.

Example 3: Taxpayer Z owns timber properties throughout the United States. During the taxable year, Z's timber properties suffered two casualties. A wild fire destroyed 4,500 acres of its timber in the Northwest. The average volume per acre for the destroyed property was 6,000 board feet (Mbf). The applicable published state severance tax schedules show a value of \$250/Mbf. A hurricane destroyed 1250 acres of Z's timber in the South. The average cords per acre for the Southern timber was 18 and the applicable price per cord per Timber Mart South was \$22. Z's timber properties are depleted in two blocks, the Northwestern block which contains 1,200,000 acres with a total basis of \$300,000,000 and a Southern block which contains 200,000 acres with a total basis of \$38,000,000. Z's gross timber loss is computed as follows: Northwest = 4,500 acres x 6 Mbf / acre x \$250 / Mbf or \$6,750,000; South 1250 acres x 18 cords / acre x \$22 / cord or \$495,000. Because the destroyed timber is in respective blocks of greater than 500,000 acres and greater than 100,000 acres but less than 300,000 acres, the gross timber loss must be reduced by twenty-five percent and fifteen percent respectively. Z's allowable loss is ((\$6,750,000 – (\$6,750,000 x 0.25) or \$5,062,500) + ((\$495,000 – (\$495,000 x 0.15) or \$420,750) equal to \$5,483,250. The total timber loss is allowable since it does not exceed the timber basis in the respective blocks.

Example 4: Taxpayer Q owns timber property in the Pacific Northwest. The Block contains 400,000 acres with a total block basis of \$60,000,000. During the 2000 tax year, Q's property suffered a casualty when a wildfire destroyed 5,000 acres of its 20

year old reproduction. The site class (50 year) was 125. The rotation age is 40 years. Based on Washington State Department of Natural Resources Report 41, *Empirical Growth & Yield Tables for the Douglas Fir Zone*, the harvest volume at age 40 will be 18.2 Mbf per acre. Based on Washington Department of Revenue Timber Excise Tax tables the stumpage value for 2000 is \$300 per Mbf. The applicable farm credit rate for 2000 is 9.82%. Q's gross timber loss is calculated as follows: 18.2 Mbf/acre x \$300/Mbf discounted at the appropriate rate (9.82%) for 20 years equals \$839 per acre. Therefore, the gross loss is \$4,193,087. Because the destroyed timber is in a block greater than 300,000 acres and less than 500,001 acres, a size adjustment of 20% is applied ($\$4,193,087 - (\$4,193,087 \times .20) = \$3,354,469$). The total loss is allowable since it does not exceed the timber basis in the block.

Additional information can be found by contacting the LMSB Forest Products site where this and other guidance will be available. <http://lmsb.irs.gov/hq/pftg/forest>

If there are any questions regarding this matter, please call Frank D. McKinney, Forest Products Technical Advisor at 770-277-1002, frank.mckinney@irs.gov, or Paula Farmer, NRC Senior Program Analyst at 713-209-3940, Paula.J.Farmer@irs.gov.

Exhibit A Timber Casualty Losses Audit Guideline
Exhibit B Issue Paper on the Valuation of a Single Identifiable Property